United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

76-7428

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P/S

In The

United States Court of Appeals

For The Second Circuit

HOWARD C. HIRSCH, PAUL L. KOHNS and MARSHALL S. MUNDHEIM,

Plaintiffs-Appellants,

-against-

EDMOND duPONT, WALLACE C. LATOUR, MILTON A. SPEICHER, FRANCIS I. duPONT & CO., F.I. duPONT GLORE FORGAN & CO. and duPONT GLORE FORGAN INCORPORATED,

Defendants,

and

HASKINS & SELLS and THE NEW YORK STOCK EXCHANGE, INC.,

Defendants-Appellees.

On Appeal from an Order of the United States District Court for the Southern District of New York.

APPELLANTS' BRIEF ON APPEAL

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UNITED STATES COURT OF APPEALS

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HOWARD C. HIRSCH, PAUL L. KOHNS and MARSHALL S. MUNDHEIM, :

Appellants, :

-against- : Docket No. 76-7428

EDMUND duPONT, WALLACE C. LATOUR, MILTON A. SPEICHER, FRANCIS I. duPONT & CO., F.I. duPONT, GLORE FORGAN & CO., duPONT GLORE FORGAN INCORPORATED, HASKINS & SELLS and NEW YORK STOCK EXCHANGE, INC., :

Appellees. :

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APPELLANTS'S BRIEF ON APPEAL

PRELIMINARY STATEMENT

This is an appeal by plaintiffs from a judgment after trial of the United States District Court for the Southern District of New York (Hon. Robert L. Carter, U.S. D.J.) entered on August 3, 1976 and an order of the same Court entered on June 5, 1975 incorporated within the aforesaid judgment in accordance with the provisions of Rule 54(b) of the Federal Rules of Civil Procedure.

STATEMENT OF THE ISSUES

1. Did the District Court err in ruling that the

New York Stock Exchange had no duty to disclose to appellants, that:

(a) Francis I. duPont & Co. had been in continuous violation of the net capital ratio requirements mandated by Section 8(b) of the Securities Exchange Act of 1934 (15 U.S.C. § 78h), the Rules of the Securities and Exchange Commission promulgated thereunder and the Rules of the New York Stock Exchange during the period between June 30, 1969 and December 24, 1969;

(b) Francis I. duPont & Co. had remedied this violation principally by means of appropriating to its own use the value of millions of dollars of securities, whose ownership was unknown by reason of chronic record keeping and account control errors of the greatest magnitude, in violation of Section 17(a) of the Securities Exchange Act of 1934 (15 U.S.C. § 78q(a)) and SEC Rule 17a-3 (17 C.F.R. §240.17a-3).

2. Did the District Court err in ruling that Haskins & Sells, auditors for Francis I. duPont & Co. and for appellants, had no duty to disclose to appellants that:

(a) Francis I. duPont & Co. had been in violation of the net capital ratio requirements mandated by Section 8(b) of the Securities Exchange Act of 1934 (15 U.S.C. § 78h), the Rules of the Securities and Exchange Commission promulgated thereunder and the Rules

of the New York Stock Exchange on its audit date, September 30, 1969, and continuing until December 24, 1969;

(b) Francis I. duPont & Co. had remedied this violation principally by means of appropriating to its own use the value of millions of dollars of securities whose ownership was unknown by reason of chronic record keeping and account control errors of the greatest magnitude, in violation of Section 17(a) of the Securities Exchange Act of 1934 (15 U.S.C. § 78q(a)) and SEC Rule 17a-3 (17 C.F.R. §240.17a-3).

3. Was the information not disclosed to appellants by Haskins & Sells and the New York Stock Exchange material to their decision to invest in Francis I. duPont & Co.

4. Did the District Court err in ruling that Haskins & Sells could not be held resonsible for the statements of Harold Petrillo, a member of the firm of Haskins & Sells, made to appellants about the condition of Francis I. duPont & Co.

5. Did the District Court err in ruling that the scienter requirements had not been met, although both the New York Stock Exchange and Haskins & Sells had knowledge of the information and failed to disclose it to appellants despite the occasion, opportunity and duty to disclose it.

6. Did the District Court err in ruling that the federal securities laws claims of appellants did not encompass their general partnership interests in Francis I. duPont & Co. when the District Court found that appellants' limited partnership interests acquired in the same transaction were encompassed by said claims.

7. Did the District Court err in refusing to recognize appellants' claim for relief against the New York Stock Exchange for violation of Section 6(b) of the Securities Exchange Act of 1934 (15 U.S.C. § 78f).

8. Did the District Court err in giving effect to waivers executed by appellants at the time of their investment in view of Section 14 of the Securities Act of 1933 (15 U.S.C. § 77n) and Section 29 of the Securities Exchange Act of 1934 (15 U.S.C. § 78cc).

STATEMENT OF THE CASE

A. The Parties and the Transaction

On July 2, 1970, the businesses of three member firms of the New York Stock Exchange, Francis I. duPont & Co. ("duPont"), a partnership, Hirsch & Co., a partnership, and Glore Forgan, Staats Incorporated, were combined into a single surviving entity. The name of the new firm, also a partnership, was F.I. duPont, Glore Forgan & Co. ("FIDGF").

As a result of this combination, appellants, each of whom had been a principal partner of Hirsch & Co., ac-

quired partnership and other interests in FIDGF. An agreement among the partners of FIDGF, dated July 2, 1970, reflects that appellant Howard C. Hirsch ("Hirsch") invested $400,000 in FIDGF in exchange for a limited partnership interest in like amount. Appellants Paul L. Kohns ("Kohns") and Marshall S. Mundheim ("Mundheim") each invested $900,000 in exchange for general partnership interests in the amount of $307,000 and limited partnership interests in the amount of $593,000. (123a, 132a).

The consideration for appellants' respective partnership interests in FIDGF was paid partly in cash and partly by application of portions of the excess in value of the assets of Hirsch & Co. transferred to FIDGF over the amount of liabilities of Hirsch & Co. assumed by FIDGF. (248a-260a, 580a-589a, 592a) This excess was determined in accordance with the provisions of an agreement between plaintiffs, Hirsch & Co. and duPont, dated July 2, 1970, based upon certain financial statements of Hirsch & Co. certified by Haskins & Sells. (326a-334a)

Haskins & Sells had been the auditors for both Hirsch & Co. and duPont for many years prior to the transaction. Haskins & Sells had also advised Hirsch & Co. and its partners with respect to general accounting and tax matters for many years, and appellants looked to Haskins & Sells, and in particular to Harold Petrillo ("Petrillo"), one of its senior members, for guidance and advice in the conduct of their business. (273a, 284a)

Petrillo, in addition to his responsibilities with respect to Hirsch, was responsible for the services rendered by Haskins & Sells to duPont. Petrillo had supervised both the 1968 and 1969 audits of duPont. (142a-143a) In 1969, Edward Lill ("Lill"), another member of Haskins & Sells, joined Petrillo on the duPont audit as part of a transaction with a view toward Petrillo's forthcoming retirement. 143a)

In both 1968 and 1969, Haskins & Sells performed "surprise" audits of duPont in accordance with the Rules of the New York Stock Exchange. The dates upon which these audits were commenced were June 30, 1968 and September 28, 1969. In addition to the preparation of statements of financial condition and the notes thereto (391a-392a), Haskins & Sells prepared Answers to Financial Questionnaire and Supplementary Schedules (Form X-17A-5) and letters, dated September 30, 1968 and November 26, 1969, respectively, entitled "Comments on Conditions referring to the Material and Substantial Inadequacies Found in the Records and Record Keeping Systems of duPont." (539a-541a, 459a-462a) In 1969, Haskins & Sells prepared a Memorandum of Computation of Net Capital and Aggregate Indebtedness of duPont as of September 28, 1969, dated November 26, 1969. (451a-458a)

Haskins & Sells issued an unqualified audit report upon duPont's published statement of financial condition as of September 28, 1969. Haskins & Sells stated in part:

> "In our opinion, the above statement presents fairly the financial position of Francis I. duPont & Co. at September 28, 1969 in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year."

These representations were reprinted with the statement of financial condition as of September 28, 1969, in duPont's annual report for the year ending December 31, 1969, along with certain unaudited figures. (391a-409a)

Haskins & Sells audit procedures included a physical securities count. This count and other audit procedures revealed substantial securities "differences" including (a) $29,980,000 of "long" securities differences, viz. securities indicated as physically possessed by duPont but whose ownership could not be traced to any specific account in the firm's records and (b) $6,950,000 of "short" securities differences, viz. securities indicated as being owned by customers of other brokers but which are not in the physical possession of duPont. (416a-144a) There is no necessary relationship between long differences and short differences, each representing different problems which may not be offset against the other. (145a-147a) Relationships between differences, if any, can only be determined by historical research of individual items by which the differences are resolved and eliminated. (148a)

In the early months of 1970, Hirsch & Co. conducted negotiations with a view toward a possible combination with

duPont. Appellants had their comptroller, Frank Gariboldi ("Gariboldi") request, receive and review certain financial data supplied by duPont. This data consisted of duPont's Answers to Financial Questionnaire as of September 28, 1969, prepared by Haskins & Sells and several Answers to Special Operations Questionnaires for the early months of 1970. (264a, 267a-286a) Although not requested to do so by appellants, Alfred Norman ("Norman"), another Hirsch & Co. employee, reviewed a portion of the data received from duPont by Gariboldi (261a) as did Thomas Weil ("Weil"), an administrative partner of Hirsch & Co. (287a) Gariboldi and Weil also had conversations with financial and administrative personnel at duPont. Neither Gariboldi, Weil nor Norman were encouraged about the transaction. They pointed out to appellants that duPont was narrowly within the net capital requirements of the Securities Exchange Act of 1934 and the New York Stock Exchange and that there were serious "back office" problems, including significant amounts of short securities differences which, although not a technical charge against capital, could result in future capital charges if not resolved. (270a, 262a, 292a-293a)

Balanced against the apprehensions of Gariboldi, Norman and Weil were (a) duPont's current Special Operations Questionnaire which showed them to be in continued capital compliance (269a, 593a-610a), (b) DuPont's most recent audited statement of financial condition which was certi-

fied without qualification by Haskins & Sells (391a-409a), (c) the absence of any action by the New York Stock Exchange to suspend duPont as a result of capital non-compliance, and (d) the New York Stock Exchange permitting duPont not to charge its capital for any part of its short securities differences. (269a, 270a)

These factors led appellants to believe that duPont, although having experienced the same cyclical recession as the rest of the industry, remained fundamentally sound in its capital base and that both its auditors and the regulatory body required to oversee its affairs had not taken any action evidencing a contrary conclusion.

As might be expected, appellants consulted with Petrillo with respect to the transaction since he was the partner of Haskins & Sells responsible for the services performed for duPont and also the partner of Haskins & Sells responsible for the services performed for Hirsch & Co. and the individual appellants. (273a, 277a) Petrillo was encouraging about the transaction. He said that the merged firm would have a good chance of success with the right management in the back office (277a, 285a). He never warned in any way against the transaction nor did he decline to express a view by reason of Haskins & Sells' dual representation. (277a-278a, 285a-286a)

On another occasion several weeks prior to the merger, Weil and Gariboldi called to Petrillo's attention the

significant amount of short securities differences shown on duPont's Special Operations Questionnaire and they questioned whether, in the light thereof, the transaction ought to go forward. Petrillo dismissed these fears stating that they were getting excited over nothing. (288a, 294a)

Appellants also consulted Lill of Haskins & Sells who had worked directly with Petrillo in supervising the 1969 audit examination of duPont. Lill had also been responsible for the audit examination of Hirsch & Co. in preparation for its merger into FIDGF. According to Lill, the principal subject of consultation between appellants and him was whether it would be possible to determine during the next audit examination of duPont whether short securities differences arose prior to or subsequent to the date of the merger. Lill advised that he did not think that he could make such a determination. (172a)

During this period, Robert Bishop ("Bishop") was a Vice President of the New York Stock Exchange. His department had the responsibility of monitoring and regulating duPont's capital and record keeping requirements. Paul Chenet ("Chenet") was the New York Stock Exchange coordinator in charge of duPont who received and reviewed the various reports of the New York Stock Exchange staff and examiners relating to duPont.

During the years 1969 and 1970, several large member member firms were experiencing capital and record keeping problems. (204a) Superior officials of the New York Stock Exchange,

such as Lee Arning ("Arning"), Senior Vice President, were studying ways of resolving these problems and were, in several instances, arranging the liquidation, reorganization and recapitalization of member firms or the combination of member firms, in order to increase the economic viability thereof. (203a-247a, 307a, 590a-591a)

The Hirsch & Co. - duPont merger was encouraged by the New York Stock Exchange as a method of creating a new duPont firm which had the potential of attracting new capital. (221a, 531a-532a) Shortly prior to the merger, the New York Stock Exchange had its own representative, Frank Dominach ("Dominach"), assigned to supervise the merger upon a full time basis to assure that it was carried out in an orderly and correct manner from the standpoint of the New York Stock Exchange.

After investigation, Dominach advised Arning, in writing, that the merger should not proceed because of duPont's unresolved record keeping problems evidenced by securities differences and because of duPont's poor capital ratio. (527a-530a) A similar opinion was held by Chenet, who also communicated his views to his superiors. (182a, 188a, 190a) These recommendations were rejected however, and the transaction was permitted to go forward.

At the time of the transaction, appellants, who were members of the New York Stock Exchange individually, were required to submit applications to the New York Stock

Exchange in order to obtain its approval of their investment and membership status as partners of the new firm contained disclaimers of reliance by appellants upon the New York Stock Exchange.

B. The Decline of duPont

Shortly after the combination of the three firms into FIDGF, the New York Stock Exchange commissioned Haskins & Sells to make a detailed study of the securities differences of duPont. An audit examination performed by Haskins & Sells as of September 27, 1970 revealed short securities differences in the amount of $19,000,000, or approximately $10,000,000 more than as reflected in the Special Operations Questionnaires of the first five months of 1970. (420a-450a) In a letter dated November 25, 1970, relating to material inadequacies in FIDGF's accounting system, internal accounting control and procedures for safeguarding securities, Haskins & Sells stated that the differences arose in large part from unresolved transactions of duPont which pre-dated the merger and many of which dated back prior to the audit examination as of September 28, 1969. (463a-467a) This situation required the creation of $15,500,000 in reserves for the short differences, thereby substantially reducing the net worth of FIDGF. (429a) In November, 1970, Bishop made formal demands on FIDGF to raise additional capital and, in the alternative, directed it to proceed with liquidation of all of its securities positions. (533a-535a)

At this time a new group of investors, headed by H. Ross Perot ("Perot"), was found to invest capital in a reorganized FIDGF. (537a-538a) Appellants, who had attempted to withdraw from FIDGF in accordance with their contractual rights, were advised by or in the presence of members of the Board of Governors of the New York Stock Exchange that in view of FIDGF's financial position, the New York Stock Exchange would not permit the withdrawal of their capital. Appellants were told that if they refused to participate in the reorganization by leaving the major part of their capital in FIDGF in the form of subordinated loans, the Perot group would not invest its capital in FIDGF and the result would be insolvency. (297a-315a) Accordingly, appellants were forced to accept subordinated indebtedness in a reorganized FIDGF for a substantial portion of their capital. (353a-385a)

In August, 1971, Haskins & Sells issued its report upon its audit examination of FIDGF as of April 30, 1971 (542a-566a) showing long securities differences of $11,000,000 and short securities differences of $29,046,911. (550a) It also provided for reserves of $42,000,000. (553a-554a) The new management of FIDGF, which had been incorporated as duPont, Glore Forgan, Inc. ("DGF"), wrote to each appellant advising that based on the Haskins & Sells audit examination, appellants had no capital in the

firm as at December 31, 1970, and therefore appellants were not entitled to any further payments upon their subordinated loans. (386a-390a)

Ultimately, and only after litigation, appellants received a part payment in settlement of the subordinated debt. This action seeks recovery of the difference between the amounts appellants invested in duPont and the total amounts recovered in the other litigation.

C. The Facts Unknown to Appellants

Appellants did not know the following material facts:

1. As of September 28, 1969, duPont had a massive capital deficiency.

2. duPont's capital deficiency was chronic, having existed for the last six months of 1969.

3. duPont's deficiency was purportedly cured shortly prior to December 31, 1969 by the liquidation of millions of dollars of long securities differences, the ownership of which could not be determined due to chronic record keeping errors.

The District Court found that the New York Stock Exchange and Haskins & Sells knew the first two items above and actively participated in the decision to take the action described in the third item.

D. The Facts Known to the New York Stock Exchange

A memorandum prepared by the Department of Member Firms of the New York Stock Exchange dated February 2, 1970* (468a-472a) contains a summary of duPont's capital situation during the period from June 30, 1969 through January 1, 1970. This memorandum, based upon capital computations calculated by the New York Stock Exchange, states that the net capital ratio of duPont as of June 30, 1969 was 2298%, that the net capital ratio as of ~~June~~ July 30, 1969 was 2181% and that the net capital ratio as of September 28, 1969 was 76,128%. The memorandum concluded:

> "These violations of Rule 325 (Capital Requirements) were not corrected until approximately December 24, 1969, when receipts of additional capital together with security positions liquidations resulted in the firm's arriving at a capital position that met the requirements of Rule 325."

Thus, on each occasion between June 30, 1969 and January 1, 1970, when duPont's capital structure was subject to independent scrutiny, duPont was found to have been significantly exceeding the permitted ratio.

This memorandum reflects that the capital situation was "corrected" on approximately December 24, 1969, by receipt of additional capital together with "securities posi-

* This memorandum was sent to duPont shortly following its preparation. It was reviewed by Chenet and Bishop. (180a, 181a) Chenet testified as to its accuracy. duPont's response to it is discussed *infra*.

tions liquidations." What the memorandum does not state, but what was clearly known to the officials of the New York Stock Exchange and Haskins & Sells, was that the "securities positions" liquidated were not proprietary positions of duPont, but were long securities differences whose ownership could not be determined from the inaccurate and incomplete records of duPont.

A memorandum dated December 16, 1969 prepared by Haskins & Sells of a meeting held at the New York Stock Exchange (567a-570a), together with a memorandum dated January 6, 1970 prepared by Chenet (524a-525a), reflect that the New York Stock Exchange clearly knew that duPont was using the proceeds from the liquidation of unresolved long securities differernces as capital. As Chenet stated in his memorandum (524a-525a):

> "The principal reason for capital improvement, however, is the sale of long securities in difference accounts."

Thus, the New York Stock Exchange knew that duPont had barely been able to comply wih capital requirements by selling securities of unknown ownership.

In fact, as Milton Speicher ("Speicher") testified, (183a-187a) with the knowledge of the New York Stock Exchange and of Haskins & Sells, $6,000,000 of such long securities differences were sold by duPont between December 16, 1969 and December 24, 1969, and the proceeds of such sales were used to correct $4,000,000 of items which

were charges against capital. The balance of the sale proceeds were infused as profit. The result of these actions was an improvement in capital ratio of $6,000,000 and an improvement in net worth of $2,000,000.

The sale of long securities differences whose ownership had not been established was a desperate and, we submit, illegal attempt to save duPont which was conceived by the New York Stock Exchange and engineered by Haskins & Sells. Lill testified that until a "difference" is researched to the point of definite resolution by attribution to a specific account, it remains a "difference" and therefore could not be considered as capital of the firm. (153a-154a) Indeed, notwithstanding the importunings of Lill and representative of duPont, the New York Stock Exchange was unwilling to accept a computation of capital ratio which gave whole or partial credit to capital for long securities differences. (567a-570a) It is, therefore, small wonder that Lill expressed his failure to understand the rationale of the New York Stock Exchange by which long securities differences, if liquidated, could result in additional capital when they were not otherwise creditable in computing the capital ratio. (168a)

E. The December 16, 1969 Meeting

Immediately following the meeting of December 16, 1969 at the New York Stock Exchange, Lill prepared a memo-

randum thereof, copies of which were sent to Speicher at duPont. This memorandum (567a-570a) and related testimony establish that the purpose of the meeting was "... to discuss the Francis I. duPont Answers to Financial Questionnaire as of September 28, 1969 and the computation of the net capital ratio relating thereto." (567a-570a) Representatives of the New York Stock Exchange advised Haskins & Sells and duPont at the meeting that the amount of $8,138,344 representing "Dividends on Securities Failed to Receive in excess of thirty days" reported on the Answers to Financial Questionnaire as at September 28, 1969 "... would be charged against net capital for Rule 325 purposes..." This item had not been charged against net capital in the Haskins & Sells computation. (451a-458a) Unlike short securities differences, as to which apparently the New York Stock Exchange exercised some discretion in requiring or not requiring a charge to be made against capital, it was the established practice of the New York Stock Exchange to charge dividends on securities failed to receive in excess of thirty days against net capital. Chenet testified that at the New York Stock Exchange this charge was not susceptible of differing interpretations. (192a) Since the New York Stock Exchange considered the dividends on securities failed to receive to represent an additional $8,138,344 charge to capital as of the audit date, duPont's

capital problems had not been resolved, notwithstanding the infusion of an additional $7,500,000 of new capital between September 28, 1969 and December 16, 1969. (567a-570a, 451a-458a, 523a) Haskins & Sells argued at the meeting that in making the capital computation some credit must be given for long securities differences. But,

> "Mr. Bishop then stated that the Exchange would not apply or give credit for such longs in the Rule 325 Capital Computation but Francis I. duPont should avail themselves of the capital benefit of the longs by liquidating the long and short differences or wherever possible, applying in Francis I. duPont's records the long differences and dividends against the short dividends and differences. He said that he strongly recommended that Francis I. duPont undertake such liquidation procedures to improve their poor Rule 325 capital position." (567a-570a)

Bishop authorized duPont to improve its capital position by liquidating long securities differences. Both Lill and Samuel Gay ("Gay"), then a duPont employee, testified that Bishop authorized such liquidation not only in the case of resolved differences where ownership has been determined by research and attributed to duPont's proprietary position, but also in situations in which research failed to determine the actual ownership of the long securities differences by any other broker or customer.

Gay's testimony also makes it clear that Bishop's suggestion and direction involved the sale of long securi-

ties differences, not the resolution of such differences. (194a-199a)

Gay testified as follows:

"Q And so then your position is that if I look through all of these things and I can't find somebody else claiming it, then it is a legitimate long difference?

"A I would say that's so.

"Q And that was the kind of a difference which you thought you could liquidate?

"A That's what I felt that Mr. Bishop meant when he talked about liquidating long differences. We should say long security count differences.

"Q At the time of this meeting, December 16th, had there been attempts to resolve these differences on a specific identification basis -- that is to say, to find that specific event or date or transaction which caused the error that gave you the stock?

"A I don't know whether you are asking me whether what I explained would be the process or a new process.

"Q No, whether some other process was in force or some other process was in operation seeking to find the specific event or transaction to which the stock apparently related.

"A If we had found the specific event we wouldn't have had the difference."

Lill's memorandum (567a-570a) clearly refers to unresolved securities differences since it discusses at length the proposition that liquidation of such differences would frustrate the escheat statutes of New York.*

In a letter to Bishop from duPont dated April 15, 1970 (567a-570a) it is made clear that the immediate liquidation of long securities differences rather than the resolution of such differences through research was intended by Bishop. That letter states, in pertinent part:

> "With your approval, and, even at your suggestion, a program of liquidation should be undertaken to reduce the firm's overages. The completion of this program, together with the additional capital raised by duPont resulted in the compliance of the firm with Rule 325 on December 24, 1969 as indicated in the staff memorandum.
>
> * * *
>
> "Any technical violation as of September 28, 1969 was not brought to our attention until December, when we were informed of proposed additional charges against our capital. Immediately, we liquidated enough of our overages so that any possible technical violation was corrected even after charging our capital with the additional $8,000,000."

Thus, it is clear that what was contemplated at the meeting of December 16, 1969 was the immediate liquidation of long securities differences. To interpret these

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* It had been anticipated that the Attorney General would assert that long securities differences remaining unresolved were unclaimed property to which the State was entitled.

documents as referring to a liquidation after the establishment of actual ownership of the securities by duPont is not logical. Immediate liquidation was obviously necessary. The resolution of differences through research is a time-consuming process which could not have been accomplished in the time available to duPont.

Rule 17a-3 (17 CFR § 240.17a-3), to which duPont and all other member firms were then subject, provided in part as at January 1, 1969:

> "Records to be made by certain exchange members, brokers and dealers.
>
> "(a) Every member of a national securities exchange ... shall make and keep current the following books and records relating to his business:
>
> "'(1) Blotters (or other records of original entry) containing an itemized daily record of all purchases and sales of securities, all receipts and disbursements of cash and all other debits and credits. Such records shall show the account for which each such transaction was effected, the name and amount of securities, the unit and aggregate purchase or sale price (if any), the trade date, and the name or other designation of the person from whom purchased or received or to whom sold or delivered.
>
> * * *
>
> "'(5) A securities record or ledger reflecting separately for each security as of the clearance dates, all 'long' or 'short' positions (including securities in safekeeping) carried by such member, broker or dealer for his account or for the account of his customers or partners and showing the location of all securities long and the offsetting position to all securities short and in all cases the name or designation of the account in which each position is carried.'"
> (Emphasis added)

It is submitted that the procedure authorized by Bishop and followed by Gay and Speicher, to the knowledge of Haskins & Sells, was an illegal way of raising capital. When one diligently searches a member firm's records and concludes that these records are unable to account for the ownership of millions of dollars worth of long securities differences, all that has been established is that the records fail to meet the requirements of Section 240.17a-3 and Rule 17a-3 promulgated thereunder in that the records fail to show "the name or designation of the account in which each position is carried." (17 CFR § 240.17a-3(a)(5)).

It is not within any discretion conferred upon the New York Stock Exchange to permit a member firm to cure massive capital deficiencies by applying the proceeds of securities as to which the most diligent research has only established that the records are inadequate and not in compliance with law. Beyond that, however, is the fact that the New York Stock Exchange was distinctly aware of a history of record keeping problems, capital compliance problems and customer complaint problems at duPont so staggering as to make it impossible to believe that duPont's systems and records were in a condition to sustain a finding that securities not belonging to a customer or another broker might properly be assumed to be the property of duPont. The evidence of the knowledge of the New York Stock Exchange of the total inadequacy of duPont's records is overwhelming.

A New York Stock Exchange staff memorandum of May 15, 1969 contains a detailed examination of the continuing record keeping problems of duPont resulting in customer complaints. (485a-491a) It states, in pertinent part:

> "However, the firm must solve some of its operational problems before any noticeable reduction in total number of problems received can reasonably be expected. Statistics seem to confirm that the number of inquiries, requests and complaints will continue to be high <u>because of the firm's operational inability especially to deliver out securities</u>. A number of neglected or poorly handled items previously reported keep reoccuring. Also a number of old problems, not previously reported, keep emerging, seeking resolution." (Emphasis added)

A confidential memorandum of the Board of Governors of the New York Stock Exchange from the Department of Member Firms contains charges against Francis I. duPont & Co. for violations of New York Stock Exchange Constitution, Article 14, Section 10 and Rules 342 and 401 during the period September 1, 1968 through October 31, 1969, and deals principally with the failure of duPont to resolve and respond to the complaints of its customers. The confidential memorandum contains a number of provisions which are noteworthy: (Underscoring added throughout)

> "Complaints to the Exchange are, literally, <u>the top of an ice-berg of customer dissatisfaction and only a part of the record of unsatisfactory service from the firms</u>.

* * *

"The SEC staff continually states that this is necessary because of the kind of problems they had observed in the firms' back offices, especially like that of duPont's inability to have control of orders, basic record-keeping, and accounting as evidenced by the firm's inability to respond to customer complaints without unreasonable delays."

The above described memorandum is of a meeting held on December 16, 1969 between representatives of duPont and the New York Stock Exchange. At this meeting, Latour of duPont stated "that a great deal of the problem was due to the fact that research of specific items was very difficult." The memorandum goes on to state that the New York Stock Exchange was informed of a $7,000,000 capital deficiency as of September 28, 1969, but that new capital had been raised and that the "...capital ratio was 1900% plus." Latour further stated "...that the firm, at the present time, has no access to any additional capital ratio was 1900% plus." ~~Thus, the meeting of December 16, 1969 occurred against a background of:~~

Thus, the meeting of December 16, 1969 occurred against a background of:

(1) chronic record keeping and customer complaint problems of unprecedented proportions;

(2) continuing net capital ratio violations from June 30, 1969 through November 26, 1969;

(3) statements by duPont that the resolution of bookkeeping differences was proceeding slowly;

(4) a statement by duPont that the firm had no access to additional sources of capital.

During the first six months of 1970, there is no evidence of any steps taken by the New York Stock Exchange to determine how duPont cured the massive capital deficiencies known to the New York Stock Exchange on December 16, 1969. The only evidence on this subject is the charge memorandum of February 2, 1970 (468a-472a) and the belated answer of duPont thereto dated April 15, 1970. (571a-579a) It is noteworthy that following the receipt of duPont's April 15, 1970 letter, the New York Stock Exchange took no disciplinary action whatsoever against duPont by reason of the matters set forth in the New York Stock Exchange's charge memorandum of February 2, 1970.

As hereinabove indicated, during these same months duPont was working on a merger with other firms in which its efforts were monitored by the New York Stock Exchange. (203a-247a, 531a-532a, 590a-591a) In June, 1970, on the eve of the merger with Hirsch & Co., both Chenet and Dominach reported to their superiors at the New York Stock Exchange that duPont's record keeping and capital problems were such as to justify their recommendation that the merger not go forward. (527a-530a, 182a, 188a-190a)

Thus summarizing, the New York Stock Exchange knew duPont had a chronic capital deficiency during the

last six months of 1969; it knew that duPont's net capital ratio as of September 28, 1969 was in excess of 76,000%; it knew that duPont had an additional $8,000,000 capital deficiency beyond the $7,000,000 deficiency computed by Haskins & Sells as of September 28, 1969; it knew that the $8,000,000 deficiency was "cured" principally by the infusion of the proceeds of long securities differences of unknown ownership based upon an examination of duPont's inadequate and unreliable records; it knew that duPont's Special Operations Questionnaire reflected its net capital ratio as within the allowable maximum and did not reveal the improper source of duPont's additional capital; and it knew that its own staff, most familiar with duPont's problems, believed that duPont's capital and record keeping problems were such as to require that the merger not go forward.

F. Facts Known to Haskins & Sells

Haskins & Sells' knowledge of the capital problems and record keeping conditions at duPont were substantially equal to those of the New York Stock Exchange.

Lill testified that Haskins & Sells was aware that duPont had been in violation of the permissible capital ratio during the period between June 30, 1969 and December 24, 1969, had "continuous ratio problems" and that communications from the New York Stock Exchange to duPont about its capital

condition during 1969 would have been made available to him in connection with the September 28, 1969 audit. (149a-152a) Haskins & Sells also knew that duPont had substantial material inadequacies in their accounting and control systems in both 1968 and 1969 with very substantial securities differences and that duPont's capital as of September 28, 1969 was 3250% with a capital deficiency of almost $7,000,000 which was not rectified by the infusion of additional capital until December. (451a-458a)

Haskins & Sells knew that the New York Stock Exchange's computation of duPont's capital deficiency was $8,100,000 higher than its own computation, resulting in a capital ratio as of the audit date of astronomical proportions. (567a-570a, 190a-191a)

Haskins & Sells also knew that duPont was advised to and did liquidate millions of dollars worth of long securities differences for the purpose of improving its capital position. (165a-168a, 187a)

Thus, during the early months of 1970, Haskins & Sells knew that duPont had been chronically exceeding the permissible capital ratio between June 30, 1969 and December 24, 1969. Haskins & Sells knew that duPont had chronic record keeping problems of a massive nature, resulting in large amounts of securities of unknown ownership, a portion of which were used by duPont for the purpose of bringing itself into purported capital compliance.

Lill disputed the fact that the New York Stock Exchange's recomputation of capital related to the audit date. It is submitted that Lill's own memorandum makes it clear that the computation and the additional capital charges which were the subject of the December 16, 1969 meeting were based upon financial information prepared by Haskins & Sells as of the audit date. Chenet made it clear in his testimony that the basis of the computations and discussions at the conference of December 16, 1969, were the audit date figures. (190a)

There is no question that Haskins & Sells left the December 16, 1969 meeting knowing that its computation of capital deficiency as of September 28, 1969 was $8,100,000 lower than as computed by the New York Stock Exchange. (164a) Haskins & Sells was advised by Speicher that long securities differences were liquidated for the purpose of achieving capital compliance. (187a) Indeed, since Haskins & Sells was consulted about the federal income tax implications of these liquidations, (168a-171a) it is clear that it knew that there were actual increments to profit and net worth as well as to capital arising from the liquidations. Lill's discussion of the escheat statutes in his own memorandum (567a-570a) also confirms that Haskins & Sells was aware that the securities being sold were unresolved securities differences.

G. The June 5, 1975 Decision of the District Court

In a decision dated June 5, 1975, the District Court

held, in granting in part a motion for summary judgment made by Haskins & Sells and the New York Stock Exchange, that the general partnership interests in duPont acquired by Kohns and Mundheim were not securities as defined in Section 3(a)(10) of the Securities Exchange Act of 1934 (15 U.S.C. § 78c(a)(10)) and Section 2(1) of the Securities Act of 1933 (15 U.S.C. § 77b(1)) (77a) but that the limited partnership interests of Hirsch, Kohns and Mundheim in duPont were securities as defined in the above-cited sections of the federal securities laws' denying the motion for summary judgment in this regard. The District Court retained jurisdiction of the pendent common law claims of Hirsch, Kohns and Mundheim with respect to both their general and limited partnership interests.

In the arguments presented by Hirsch, Kohns and Mundheim in opposing the motion for summary judgment, it was urged that if the District Court found (as it did) that both securities (the limited partnership interests) and non-securities (the general partnership interests) were conveyed, the District Court could sustain the federal securities law claim with respect to the entire transaction. The District Court rejected this argument, (70a-71a) and it is solely this portion of the June 5, 1975 decision which is the subject of this appeal. The legal arguments with respect to this issue are set forth in Point IV, <u>infra</u>.

H. <u>The Ruling of the District Court at Trial</u>

At the commencement of the trial of this action,

counsel for Hirsch, Kohns and Mundheim requested that they be allowed to submit evidence of violat on of Section 6(b) of the Securities Exchange Act of 1934 (15 U.S.C. § 78a(b)). This request was denied by the District Court which stated no such claim for relief was set forth in the amended complaint and that to allow such a claim at the time of trial would prejudice the New York Stock Exchange.

As will be demonstrated in Point III, infra, all of the required elements of a private action for violation of Section 6(b) were set forth in the amended complaint. Although Section 6(b) was not expressly mentioned in the amended complaint, accepted standards of pleading do not require enumeration of section numbers. Furthermore, the New York Stock Exchange was aware more than one year prior to trial and throughout the discovery process that a private right of action for violation of Section 6(b) was asserted.

Under these circumstances, it is submitted that the District Court erred in refusing to recognize the Section 6(b) claim for relief of Hirsch, Kohns and Mundheim.

I. The Decision After Trial

The central issue in this action was the failure of the District Court to recognize the statutory duties imposed upon the New York Stock Exchange by Congress with respect to regulation of its member firms.

The District Court found that the New York Stock Exchange knew of the continuing net capital ratio violations by duPont and the manner in which these violations were cured. Despite these findings, the District Court held that the New York Stock Exchange had no duty to disclose this information. As will be demonstrated in Point I, infra, the New York Stock Exchange was obligated by statute to suspend the operations of duPont which would have caused the disclosure of these facts. This statutory obligation cannot be waived, avoided or diminished and was not, as the District Court ruled, subject to the discretion of the New York Stock Exchange. The Distict Court found:

> "On December 16, 1969, representatives of NYSE, H&S and FID met to discuss ways and means to resolve the firm's net capital compliance problems. As a general practice, research usually conshort differences because the extent of such differences constitutes a potential firm exposure to liability. At the December 16th meeting, however, Robert Bishop, Vice President of NYSE, suggested that in view of FID's net capital compliance problems, the security long differences might prove the most fruitful area for immediate research since there was a likely prospect that such research would establish that a sizable portion of the securities in the long differences category probably belonged to FID. The suggestion was followed, and the firm liquidated enough of its security long differences to bring it into net capital compliance by the end of 1969."

The District Court did not recognize, although Lill so testified, that the research necessary to resolve differences was a painstaking process requiring many months. Although duPont did not consider long securities differences as a source of potential capital until the suggestion of the New York Stock Exchange on December 16, 1969, research with respect to more than $6,000,000 of such differences was miraculously accomplished by December 24, 1969. Also disregarded was the uncontradicted testimony that the "research" amounted to nothing more than determining that the ownership of any given security could <u>not</u> be determined. To conclude therefrom that these securities were the property of duPont is certainly questionable in view of the massive record keeping and internal accounting problems which duPont was experiencing. The creation of both capital and profit therefrom is beyond justification.

The District Court also erred in its consideration of the waiver and exculpation clauses contained in applications to the New York Stock Exchange executed by Hirsch, Kohns and Mundheim in connection with this transaction. By recognizing these clauses as being effective, the District Court disregards Section 14 of the Securities Act of 1933 (15 U.S.C. § 77n) and Section 29 of the Securities Exchange Act of 1934 (15 U.S.C. § 78cc), which expressly provide that agreements which constitute waivers of violations of the respective federal securities laws are void.

The District Court's finding that the information withheld from Hirsch, Kohns and Mundheim was not material merely because they failed to inquire about it is also erroneous. The finding that Hirsch, Kohns and Mundheim "could have and would have secured this information if they had considered it of consequence" begs the issue. Hirsch, Kohns and Mundheim did not give consideration to 1969 financial data because they had no reason to know or believe that duPont had a capital deficiency for a period of more than six months and that it was "cured" in the outrageous manner previously described. The 1970 financial information gave no indication of the activities which occurred in the last months of 1969. Yet, these activities resulted in a completely false picture of the financial and operational stability of duPont in 1970.

Indeed, the inquiries of Hirsch, Kohns and Mundheim to both Lill and Petrillo which could have resulted in disclosure of the 1969 activities, instead resulted in assurances that the problem of securities differences was not significant.

With respect to Haskins & Sells, there is simply no basis in the record for the finding that "Petrillo ... seems to have been acting personally and not in the capacity of a partner in H&S." Petrillo did not testify and the only testimony with respect to his statements was made by Hirsch, Kohns and Mundheim which was clear that Petrillo

was consulted professionally as the partner in charge of the duPont audit examination.

Furthermore, Haskins & Sells made no effort to disclose that the New York Stock Exchange found duPont to have been in violation of net capital requirements on both the audit date and the date of the audit report. This finding by the New York Stock Exchange drastically affected the viability of duPont as reflected in its financial statements. It is submitted that Haskins & Sells was obligated to withdraw or condition its audit report upon being so informed.

Finally, the District Court found that there was no evidence of either intent to defraud or willful or reckless disregard of the truth. Yet, as previously described, both the New York Stock Exchange and Haskins & Sells knew of and participated in the activities of which Hirsch, Kohns and Mundheim were not informed. Both the New York Stock Exchange and Haskins & Sells had opportunity, occasion and, we submit, the duty to disclose these activities.

ARGUMENT

POINT I

THE NEW YORK STOCK EXCHANGE AND HASKINS & SELLS IMPROPERLY FAILED TO DISCLOSE MATERIAL INFORMATION TO APPELLANTS

A. The New York Stock Exchange

In finding that the New York Stock Exchange had not violated Section 10(b) and Rule 10b-5, the District

Court stated:

> "The NYSE had knowledge of FID net capital compliance problems and its back office weaknesses as well, but it has no obligation that I have been able to discover requiring that it disclose to member firms in merger negotiations whatever it knew about the firms in question. While a 10b violation may occur by an affirmative misrepresentation or by an omission that a reasonable man would consider important to his decision--in this instance to consummate the merger--see List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir.), cert. denied, 382 U.S. 811 (1965), or might have considered important to that determination, Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1910), mere inaction absent a duty to act does not suffice, see Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973) (en banc); Wessel v. Buhler, 437 F.2d 279 (9th Cir. 1971)."

It is submitted that the District Court erred in the analysis set forth above:

(a) by disregarding the statutorily imposed limits upon the discretion of the New York Stock Exchange in dealing with the capital problems of its member firms;

(b) by disregarding the direct involvement of the New York Stock Exchange in the concealment of duPont's financial crisis and in monitoring the merger between duPont and Hirsch & Co. and the financial interest of the New York Stock Exchange and its member firms in the transaction, which also create a duty of disclosure; and

(c) by disregarding the more reasoned authority to the effect that inaction and silence are a sufficient

basis for a violation in the presence of a duty of disclosure and the requisite scienter.

1. The Duty of Disclosure

The requirement that duPont maintain a 2000% capital ratio was imposed by Congress in Section 8(b) of the Securities Exchange Act of 1934 (15 U.S.C. § 78h) and is not merely a discretionary rule of the New York Stock Exchange or the Securities and Exchange Commission. We submit that it was not within the New York Stock Exchange's power to waive the rule, ignore its chronic and substantial violation or participate in the concealment of its violation. While the New York Stock Exchange may have some discretion in the administration of the rule, it does not extend to the active concealment of the violation and of the method by which it was purportedly "cured".

Pursuant to Congressional mandate, every member firm of a national securities exchange is prohibited by Section 8(b) from permitting its aggregate indebtedness to exceed 2000% of the net capital employed therein. The language of Section 8(b), in relevant part, reveals the limited discretion, within the bounds of the 2000% requirement, which Congress delegated to the Securities and Exchange Commission and the New York Stock Exchange.

> "It shall be unlawful for any member of a national securities exchange or any broker or dealer who transacts a business in securities through the medium of any such member, directly or indirectly --

* * *

> "(b) To permit in the ordinary course of business as a broker his aggregate indebtedness to all other persons, including customers' credit balance (but excluding indebtedness secured by exempted securities), to exceed such percentage of the net capital (exclusive of fixed assets and value of exchange membership) employed in the business, but not exceeding in any case 2,000 per centum, as the Commission may by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors." (Emphasis added)

Thus, the Securities and Exchange Commission may prescribe a percentage which is <u>more</u> restrictive than 2000% but its discretion is, however, clearly circumscribed by the Congressionally imposed ceiling. Significantly, the ceiling of 2000% must be adhered to by member firms whether or not the Securities and Exchange Commission exercises its power to fix a ratio pursuant to Section 8(b). The mandatory nature of the 2000% prohibition on member firms is effectively emphasized in both the Senate and House Reports accompanying the Securities Exchange Act of 1934.

> "Subsection (b) prohibits a member, broker, or dealer to permit his indebtedness (except on exempted securities) in the ordinary course of business as a broker to exceed 2,000 percent of his net capital or such lower percentage thereof as the Commission may prescribe."

H. R. Rep. No. 1383, 73d Cong., 2d Sess. 20 (1934); S. Rep. No. 792, 73d Cong., 2d Sess. 16 (1934).

That the 200% net capital ratio is both mandatory and Congressionally imposed was expressly acknowledged by the Securities and Exchange Commission when it extended the statutory approach to insuring financial responsibility to non-member firms. SEC Release No. 3322 (October 29, 1942) states:

> "First, in dealing with the problem of financial responsibility as it relates to members of national securities exchanges and brokers and dealers who do business through such members, Congress has used the ratio method and it has prescribed a ratio between net capital and aggregate indebtedness similar to that provided in our rule. Section 8(b) of the Securities Exchange Act of 1934 provides that:
>
> * * *
>
> "Thus, there will be extended to all brokers and dealers who extend credit to customers or carry money or securities for the account of customers or owe money or securities to customers <u>substantially the same requirements now imposed upon members of national securities exchanges and brokers and dealers who do business through such members by Section 8(b) of the Securities Exchange Act</u>." (Emphasis added). See SEC Net Capital Rule, 17 CFR § 240.15c3-1.

The regulations adopted by the Securities and Exchange Commission imposing capital requirements on broker-dealers who were non-members were adopted pursuant to Section 15(c)(3) which gave the Securities and Exchange Commission power to adopt regulations governing broker-dealers in the public interest. When these regulations were adopted,

firms were excluded therefrom upon the express statement that such firms were regulated more comprehensively by rules of their own exchanges. (SEC Release No. 3617 (November 8, 1944.))

The Securities and Exchange Commission exemption from its capital ratio rules did not and could not apply to an exemption of member firms from the ratio requirement imposed by Congress under Section 8 (15 U.S.C. § 78h(b)) which had been in force prior to the Securities and Exchange Commission's regulations and has remained in force ever since, essentially unchanged. Similarly implementive provisions concerning methods of computation adopted by the Securities and Exchange Commission are inapplicable because similar New York Stock Exchange rules deemed more comprehensive cover the same problems. The requirement of a 2000% ratio is one imposed by Congress, not by Rule 325 of the New York Stock Exchange and this is made clear from the statute itself and the legislative history (H.R. Rep. No. 1383, 73d Cong., 2d Sess. 20 (1934); S. Rep. No. 792, 73d Cong., 2d Sess. 16 (1934)).

Since the 2000% ratio is a statutory requirement and not of the internal rules of a commercial association enjoying an exemption from Securities and Exchange Commission regulations, the discretion of the New York Stock Exchange to relax, vary, waive or overlook abrogations and violations in order to "save" a member firm must be deemed extremely limited.

As the Supreme Court held in Silver v. New York Stock Exchange, 373 U.S. 341, 351 (1962), to hold that registered exchanges have discretion as to whether those rules will be enforced would leave the exchanges in the socially unacceptable status of private clubs which existed before the passage of the Securities Exchange Act of 1934.

It must be remembered that the duPont financial crisis was a major portion of a greater problem threatening the New York Stock Exchange in 1969 and 1970. The disclosure of duPont's truly precarious situation would have created serious financial problems for the New York Stock Exchange and its member firms. Arning conceded that the New York Stock Exchange was vitally interested in encouraging a transaction between duPont and others resulting in a new entity which was financially and operationally sound. For these reasons, the merger was carefully monitored by the New York Stock Exchange. Yet when its examiner urged halting the merger a position endorsed by his immediate superior Chenet, the New York Stock Exchange chose to allow the merger to proceed. (See pages 10-11, supra)

The reaction of the New York Stock Exchange to these problems was not that of a regulatory agency subject to statutory prescriptions, but rather that of a commercially-interested business cooperative faced with internal problems which must be disposed of quickly and

quietly. The New York Stock Exchange argues that publicity would have made it impossible to resolve duPont's capital problems, thus justifying their failure to disclosure. However, as noted in Fischer v. New York Stock Exchange, 408 F.Supp. 745, 754, fn. 10 (S.D.N.Y. 1976):

> "The issue here, however, is not one of general public disclosure, but of disclosure to investors in member firms. It is not unreasonable to question whether a private investor who considers placing his assets at the risk of the management of an Exchange member may not, at least under some circumstances, be entitled to the benefit of the Exchange's knowledge bearing on the severity of that risk. The statute on which this action is based, after all, favors the widest possible disclosure in securities transaction."

If the New York Stock Exchange had some discretion in dealing with the duPont financial crisis, the actions taken clearly constituted an abuse of that discretion. duPont's continued history of record keeping problems, its "operational inability to deliver out stock", its unprecedented number of customer complaints, the reports of Haskins & Sells in 1968 and 1969 with respect to the material inadequacies of duPont's accounting and internal control systems, and the recognition by duPont's management that resolution of differences was a slow, time-consuming process -- all of which were known to the New York Stock Exchange (see pages 15-17 and 23-27, supra) -- militate the conclusion that immediate resolution of a massive capital deficiency should not have been permit-

ted through liquidation of long securities differences. It is inconceivable that duPont could use its records to resolve massive securities differences in a matter of days when these very records created the differences, as well as duPont's capital deficiencies, in the first instance. Simply stated, the New York Stock Exchange suggested that the very problems causing duPont's financial crisis could be used to resolve it.

These circumstances are analogous to those in Hughes v. Dempsey-Tegeler & Co., Inc., CCH Fed. Sec. L. Rep. (1975-1976 Transfer Binder) ¶ 95,513 (9th Cir. 1976). The Ninth Circuit held at 99,618:

> "The Exchange had earlier attributed Dempsey's operational and financial problems in large part to the firm's inability to process its volume of business. The restrictions were generally designed to reduce that volume to a point at which the firm could handle it. In lifting the restrictions, the Exchange invited an aggravation of the very problems which had prompted the restrictions in the first place. The Exchange has presented nothing to support an argument that the restrictions were no longer necessary."

The Ninth Circuit concluded at 99,618:

> "If the Exchange determined that the lower level restrictions had not succeeded, it was obligated to suspend the firm. Instead, its attempted resolution so ignored the Exchange's duty owed to investors and potential investors in Dempsey that it far exceeds any permissible degree of discretion or flexibility in choosing a response."

It is submitted that a similar, but more obvious, breach of the duty of the New York Stock Exchange occurred in this case.

The solution chosen by the New York Stock Exchange to duPont's capital problems had the effect of concealment. Once the long securities differences were liquidated and the proceeds infused into the capital of duPont, it was impossible to ascertain from duPont's publicly available financial and operational data that the foregoing had occurred.

The District Court, in ruling that the New York Stock Exchange was under no duty of disclosure, gave no consideration to its direct participation in the December, 1969 events or to its monitoring activities. It has been clearly established that consideration of such factors is proper and necessary in determining the presence of a duty of disclosure. See White v. Abrams, 495 F.2d 724, 735-736 (9th Cir. 1974) and Carr v. New York Stock Exchange, CCH Fed. Sec. L. Rep. (1975-1976 Transfer Binder) ¶ 95,563 at 99,810.

As stated in Brennan v. Midwestern United Life Insurance Company, 259 F.Supp. 673, 681-682 (N.D. Ind. 1966):

> "Certainly, not everyone who has knowledge of improper activities in the field of securities transactions is required to report such activities. This court does not purport to find such a duty.

Yet duties are often found to arise in the face of special relationships, and there are circumstances under which a person or a corporation may give the requisite assistance or encouragement to a wrongdoer so as to constitute an aiding and abetting by merely failing to take action."

2. Inaction or Silence as a Basis of Liability

The District Court ruling justifying the inaction of the New York Stock Exchange was based in part upon Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973) and Wessel v. Buhler, 437 F.2d 279 (9th Cir. 1971).

The conclusion reached by the Ninth Circuit in Wessel, supra, that inaction was not a sufficient basis for liability was expressly rejected by the Seventh Circuit in Hochfelder v. Midwest Stock Exchange, 503 F.2d 364, 374 (7th Cir. 1974) as follows:

> "[W]e are not prepared to hold that a claim for aiding and abetting solely by inaction cannot be made under Rule 10b-5. In invoking such a rule, however, we would not go so far as to charge a party with aiding and abetting who somehow unwittingly facilitated the wrongful acts of another. Rather, to invoke such a rule investors must show that the party charged with aiding and abetting had knowledge of or, but for a breach of duty of inquiry, should have had knowledge of the fraud, and that possessing such knowledge the party failed to act due to an improper motive or breach of a duty of disclosure." (Emphasis added)

Furthermore, the recent decision by the Southern District of New York in Fischer v. New York Stock Exchange, supra, at 753, specifically rejected the notion that the Lanza case precluded liability based upon inaction alone:

> "The principal focus of the court's concern was the mental element of the offense, and the holding of Lanza is that scienter of a degree at least greater than negligence is a necessary predicate to 10b-5 liability ... The court's discussion, however, does not preclude the possibility that liability for aiding and abetting might attach on the basis of inaction alone, providing the requisite scienter exists." (Emphasis added)

Thus, inaction or silence in the presence of a duty of disclosure arising from the particular circumstances involved does give rise to liability upon a showing of the requisite scienter.

3. Scienter

The recent Supreme Court decision in Ernst & Ernst v. Hochfelder, U.S. , 96 S.Ct. 1375 (1976), establishes that scienter is a necessary element to the imposition of liability under Section 10(b) and Rule 10b-5. This was previously recognized by the Second Circuit in Lanza v. Drexel & Co., supra, at 1301, 1306. The Supreme Court left open the issue of whether actual intent to defraud was necessary or whether recklessness was sufficient. It noted that:

> " ... In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under §10(b) and Rule 10b-5."

This Circuit has repeatedly held that recklessness is sufficient for the imposition of liability. See Shem-

tob v. Shearson, Hammill & Co., 448 F.2d 442, 445 (2d Cir. 1971) and Lanza v. Drexel & Co., supra, at 1306. The Second Circuit noted, in Lanza, supra, at fn. 98, 1306:

> "In determining [what] constitutes 'willful or reckless disregard for the truth' the inquiry normally will be to determine whether the defendants knew the material facts misstated or omitted, or failed or refused, after being put on notice of a possible material failure of disclosure, to apprise themselves of the facts whether they could have done so without any extraordinary effort."

The District Court found that the New York Stock Exchange knew the facts in question and did not disclose them. In the presence of a duty to disclose these facts, the failure of the New York Stock Exchange to do so is sufficient to establish the requisite scienter.

As is stated in Rochez Bros., Inc. v. Rhoades, 491 F.2d 402, 407-408 (3d Cir. 1974):

> "Defendant was under a duty to disclose all material facts to plaintiff, and his failure to do so when he had actual knowledge of those facts satisfies any scienter requirement."

See also McLean v. Alexander, CCH Fed. Sec. L. Rep. (current) ¶ 95,725 at 90,551.

4. Materiality

The finding by the District Court that the facts in question were not material to Hirsch, Kohns and Mundheim was both legally and factually erroneous. The District Court stated:

"The actions of plaintiffs and their representatives during the negotiations belie any contention that FID conditions in 1969 would have been or might have been material to plaintiffs' decision to join forces with FID in July, 1970, or that they placed any reliance on any supposed understanding of FID's 1969 status based upon any misrepresentation to or concealment from them by NYSE in making the decision to go forward with the merger plan."

Apparently, the District Court applied a subjective test in determining the issue of materiality. However, it is well established that materiality is measured by an objective test which asks whether a reasonable man might attach importance to the misrepresentations or omissions in determining his course of action. See List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir. 1965); Rochez Bros., Inc. v. Rhoades, supra, at 408, and McLean v. Alexander, supra, at 90,545.

That duPont had been in continuing violation of the net capital requirements imposed by Congress for more than six months was clearly of importance to a prospective investor in duPont. Of even greater importance was the liquidation of long securities differences in the manner previously described, creating $6,000,000 in capital and $2,000,000 in profit. (See pages 16-17, supra)

The District Court belittled these facts as pertaining to the financial condition of duPont in 1969 which would not be pertinent to its financial condition some six months

later. This reasoning disregards the fact that in June, 1970, the amount of net capital in excess of the minimum requirement was only $2,208,000. The materiality of the dubious nature of $6,000,000 of duPont's capital is clearly evident.

Furthermore, the perilous condition of duPont in the month immediately prior to the merger was sufficiently material to cause the New York Stock Exchange examiner assigned to monitor the merger to opine that it should not forward. (See page 26, <u>supra</u>) This opinion was affirmed by Chenet but rejected by Arning and Bishop for the reasons previously described. There is no evidence, however, that anyone at the New York Stock Exchange considered this information unimportant or so lacking in merit as to be unworthy of consideration.

Under these circumstances, here can be no doubt as to the materiality of the information withheld from Hirsch, Kohns and Mundheim.

5. <u>Reliance</u>

Although the District Court recognized that proof of reliance in non-disclosure cases is unncessary, it held that:

> " . . . if what was withheld was relied upon and might have been material to their decision, . . . , the plaintiffs could have and might have secured this information if they had considered it of consequence."

As stated in <u>Affiliated Ute Citizens</u> v. <u>United States</u>, 406 U.S. 128, 153-154 (1972):

> "Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision. [citations omitted] This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact."

Similarly, in McLean v. Alexander, supra, at 90, 546 it was held:

> "In non-disclosure actions because of the insurmountable difficulties of proof, no significant showing of reliance is required. In such actions the materiality of the statement presupposes reliance and the 'causation in fact' test is substituted for positive proof of causation."

See also Shapiro v. Merrill Lynch, 495 F.2d 228 (2d Cir. 1974) and Harnett v. Ryan Homes, Inc., 496 F.2d 832, 838 fn. 20 (3d Cir. 1974).

Thus, with respect to Hirsch, Kohns and Mundheim, the applicable test, which is one of causation and not reliance, is whether they would have been influenced to act differently than they did had the New York Stock Exchange disclosed the facts to them. See McLean v. Alexander, supra, at 90,546, List v. Fashion Park, Inc., supra at 463, and Rochez Bros., v. Rhoades, supra, at 411.

There is simply no evidence in this record that Hirsch, Kohns and Mundheim would have acted in the same man-

ner if they were aware of the undisclosed information. Hirsch, Kohns and Mundheim testified that they would have rejected this merger had they known of the "resolution" of duPont's chronic capital problem by the sale of long securities differences as previously described. Although the District Court itemized the factors considered by Hirsch, Kohns and Mundheim in entering into this transaction, there is no evidence that they would have done so had they been aware of the undisclosed information. It is submitted that there are always reasons why a transaction is attractive to its participants, and the mere recitation of those reasons does not establish, as it was the burden of the New York Stock Exchange to do, that knowledge of other facts would have been disregarded.

The District Court also found that Hirsch, Kohns and Mundheim failed to exercise the due care to be expected of sophisticated businessmen. Initially, it must be noted that no amount of business acumen would have aided in the discovery of the information withheld. The sale of the long securities differences and the use of the proceeds to cure a chronic capital deficiency could not have been detected by anyone not participating in the transaction. While comparison of the amount of long securities differences set forth in the September 28, 1969 financial statements and the amount appearing in the duPont Special Operations Questionnaires during the early months of 1970 would have revealed a decrese, it may properly be reason-

ed that this decrease resulted from a well-researched resolution of the long securities differences. Although such research might have been accomplished within six months, it clearly could not have been accomplished within the days following the December 16, 1969 meeting. As recognized in Straub v. Vaisman, CCH Fed. Sec. L. Rep. (Current) ¶95,623 at 90,110 (3d Cir. 1976), and McLean v. Alexander, supra, at 90,548, where there is no access to the critical information nor opportunity to discover the fraud, even the sophisticated investor can be defrauded.

Furthermore, where it is unnecessary to prove actual reliance as in non-disclosure cases, it is futile to ask whether such reliance was subjectively justifiable because of business sophistication. See McLean v. Alexander, supra, at 90,548. Also, in view of the scienter requirements firmly established in Ernst & Ernst v. Hochfelder, supra, the recognition given to the due diligence defense, which is in the nature of contributory negligence, must be questioned. See Straub v. Vaisman, supra, at 90,110, and McLean v. Alexander, supra, at 95,548.

Most certainly in this case, where the New York Stock Exchange had actual knowledge of material information which it withheld despite a duty of disclosure, and where the information withheld was not readily ascertainable, the due diligence defense should not be applied.

Finally, the District Court found that the position of Fraiman, a partner in Hirsch & Co. upon the Board of Governors of the New York Stock Exchange, provided access to the information in issue. Yet, there is no evidence suggesting that Fraiman or any member of the Board of Governors was actually aware of such information. Indeed, Fraiman also invested personally in duPont. Furthermore, the suggested use by Fraiman of his position upon the Board of Governors as a mechanism for investigating a competing entity is of questionable propriety.

B. <u>Haskins & Sells</u>

The District Court, in finding no liability on the part of Haskins & Sells stated:

> "H&S was under no obligation to disclose any information to plaintiffs concerning their 1969 audit or net capital computations of FID. H&S was not acting in a professional consultative capacity to plaintiffs in respect of the merger."

The District Court found that Haskins & Sells knew these facts and did not disclose them. The analysis of the a duty of disclosure is set forth at length with respect to the New York Stock Exchange and will not be repeated with respect to Haskins & Sells. It is sufficient to note that based upon the circumstances described below, a duty of disclosure on the part of Haskins & Sells did exist and that its inaction in the face of such duty is sufficient to establish its liability.

The unqualified opinion of Haskins & Sells accompanying the financial statements of duPont as of September 28, 1969, did not disclose that duPont had been in violation of the capital requirements on September 28, 1969, and that this violation had been purportedly cured by November 26, 1969, the date of the Haskins & Sells opinion. (See pages 6-7, supra) The implications of a capital deficiency have been previously described and, even though allegedly remedied, it should have been disclosed by way of footnote. Lill agreed that the following accounting principles, which were in part authored by him in 1973, were equally applicable in 1969:

> "A violation of the applicable net capital rules as of the audit date requires footnote disclosure and may require the independent public accountant to qualify his opinion because of 'going concern' considerations. However, there may be situations in which the capital deficiency is corrected prior to the issuance of the independent public accountant's report. In these circumstances footnote disclosure may be adequate."

On December 16, 1969 Haskins & Sells was informed by the New York Stock Exchange that an additional capital deficiency of $8,100,000 was being charged to duPont as of September 28, 1969. (See page 18, supra) Once aware of this information, Haskins & Sells had the obligation to satisfy itself that this additional capital deficiency, charged as of the audit date, was cured, or to modify or withdraw its opinion with respect to duPont's financial statements. The record in this action

is barren of any evidence which even suggests that Haskins & Sells reviewed the sufficiency of the method by which this capital deficiency was "cured". In view of the recurring reports issued by Haskins & Sells upon the material inadequacies of duPont's records and systems, (see page 6, supra) it cannot be claimed now that the sale of long securities differences based solely upon a determination that the records failed to disclose true ownership was sufficient.

The obligation of an accountant to correct or modify previously issued financial statements is well established. In United States v. Natelli, CCH Fed. Sec. L. Rep. (1975 - 1976 Transfer Binder), ¶95,250 at 98,298, this Court held:

> "The accountant has a duty to correct the earlier financial statement which he had audited himself and upon which he had issued his certificate, when he discovers 'that the figures in the annual report were substantially false and misleading', and he has a chance to correct them."

See also Fischer v. Kletz, 266 F.Supp. 180 (S.D.N.Y. 1967) and Gold v. DCL, Incorporated, CCH Fed. Sec. L. Rep. (1973 Transfer Binder), ¶94,168 where it is stated:

> "The importance of the act of certifying is such that a continuing duty to disclose has been imposed where the auditor learns facts revealing that a certification believed correct when issued was actually unwarranted."

That Haskins & Sells did not prepare the financial statements specifically for Hirsch, Kohns and Mundheim does not negate the duty owed by Haskins & Sells to them. As stated in McLean v. Alexander, supra, at 90,554:

"Courts have uniformly recognized a duty between professionals and third parties under the federal securities law as well as the common law.

***

"An accountant who expects and has special reason to know that his report will be used by members of the investing public . . . has little room for complaint when in fact his report is so used. Liability in such a situation is easily established."

Haskins & Sells was aware of the merger negotiations and knew that Hirsch, Kohns and Mundheim would be relying upon their previously issued financial statements. (See pages 9-10, <u>supra</u>) Haskins & Sells also knew that these financial statements did not disclose the events on December 16, 1969 and the days following. In <u>Fischer</u> v. <u>Kletz</u>, <u>supra</u>, at 185, the Court, citing 2 Prosser, Torts, at 534 (2d ed. 1955) held that:

"'one who has made a statement and subsequently acquires new information which makes it untrue or misleading, must disclose such information to any one whom he knows to be still acting on the basis of the original statement***'."

Beyond the failure of Haskins & Sells to modify or withdraw its opinion with respect to duPont's financial statements, are the direct representations made by Petrillo to Hirsch, Kohns and Mundheim responding to the very problem of securities differences. (See pages 9-10, <u>supra</u>) The substance of these statements is undisputed. Petrillo not only communicated favorably with respect to the impending merger but specifically rejected the concerned ~~the concerned~~ in-

quiries as to the large amounts of securities differences and the record-keeping problems of duPont relating thereto. Although Petrillo did <u>not</u> testify at the trial, the District Court concluded that:

> "Petrillo, however, seems to have been acting personally and not in the capacity of a partner in Haskins & Sells."

Hirsch, Kohns and Mundheim all testified that that inquiries directed at Petrillo sought his professional opinion as the partner of Haskins & Sells responsible for auditing duPont. There is no evidence, testimonial or documentary, to refute this testimony. The conclusion reached by the District Court is therefore without support in this record and clearly erroneous.

Haskins & Sells directly participated in the events of December 16, 1969 which were not disclosed to Hirsch, Kohns and Mundheim. It knew that the absence of any qualification in its most recent opinion with respect to the financial statements of duPont was of material importance to Hirsch, Kohns and Mundheim and its opinion should have reflected the events of December, 1969 by means of a subsequent qualification. Haskins & Sells was specifically asked, through Petrillo, about the question of securities differences and related record-keeping problem. It is submitted that these circumstances demonstrate the existence of a duty of disclosure.

In the presence of such a duty, actual knowledge of the facts and the failure to disclose them, the liability of Haskins & Sells to Hirsch, Kohns and Mundheim is clear. The arguments with respect to materiality, scienter and reliance previously set forth as to the New York Stock Exchange are equally applicable to Haskins & Sells and shall not be repeated.

POINT II

THE DISTRICT COURT ERRED IN GIVING EFFECT TO THE WAIVER PROVISIONS OF THE APPLICATIONS EXECUTED BY APPELLANTS

As previously stated, Hirsch, Kohns and Mundheim each executed, at the time of their investments in duPont, applications to the New York Stock Exchange pertaining to a change in the status of their membership. (See pages 11-12, supra) These applications contained standard form printed statements to the effect that their investment in duPont was not being made in reliance in any manner upon the New York Stock Exchange. The District Court held that Hirsch, Kohns and Mundheim, as knowledgeable, sophisticated businessmen, should be bound by the statements made in their respective applications.

In so ruling, the District Court relied upon Pollak v. Eastman Dillon [1974-1975 Transfer Binder] CCH Fed. Sec. L. Rep. ¶94,987 (S.D.N.Y. 1975), which does not deal in any manner with the issue of waiver of liability under the Securities

Exchange Act of 1934 or the Securities Act of 1933. The District Court entirely disregarded Section 14 of the Securities Act of 1933 (15 U.S.C. ¶77n) and Section 29 of the Securities Exchange Act of 1934 (15 U.S.C. ¶78cc) which provide that waivers of compliance with the provisions of the federal securities laws and the rules of the Securities and Exchange Commission promulgated thereunder are void.

Sections 14 and 29 do not, as written, allow for the exercise of judicial discretion in considering waivers of liability. Although it has been held that these sections may not be applicable to waivers or releases of matured claims under certain circumstances, see Mittendorf v. J. R. Williston & Beane, 372 F.Supp. 821, 833-836 (S.D.N.Y. 1974), it has never been held that an anticipatory release was sustainable due to surrounding circumstances such as the sophistication of the releasing party. Unlike the Mittendorf case, supra, this action does not involved the knowing waiver of a matured claim or the execution of a release in connection with the settlement of pending litigation. Accordingly, sophistication in the securities industry is not a proper base upon which to uphold the validity of the waivers. In this respect, Judge Frankel stated in Schine v. Schine, 254 F.Supp. 986 (S.D.N.Y. 1966) at 988:

> "It would be at least highly anomalous . . . to hold under section 29(a) that a party, without knowing the facts, could effectively bar himself by a release from suing for fraud in the transaction of which the release was part."

Finally, as stated by Judge Tyler in Cohen v. Tenney Corporation, 318 F.Supp. 280 (S.D.N.Y. 1970) at 284:

> "Judicial hostility toward waivers generally requires that the right of private suit for alleged violations be scrupulously preserved against unintentional or involuntary relinquished."

It is apparent that a contemporaneous waiver of reliance is the equivalent of sustaining a waiver of liability in these circumstances. Such a precedent would clearly frustrate the remedial purposes of the federal securities laws and should not be sustained.

POINT III

THE DISTRICT COURT ERRED IN REFUSING TO RECOGNIZE APPELLANTS' SECTION 6 CLAIM FOR RELIEF

As previously stated, the District Court refused to recognize that a claim for relief against the New York Stock Exchange for violation of Section 6(b) of the Securities Exchange Act of 1934 was asserted in their amended complaint. It ruled that the assertion of such a claim for relief at the commencement of trial was not timely and that the New York Stock Exchange would be prejudiced if it were allowed.

It is submitted that every element of a private right of action for violation of Section 6(b) by the New York Stock Exchange was pleaded with particularity in the amended complaint.

The existence of a private right of action for violation of Section 6 of the 1934 Act has been established since Baird v. Franklin, 141 F. 2d 238 (2d Cir. 1944), and has been reaffirmed in this Circuit and elsewhere. See Buttermwalston & Co., Inc, 387 F. 2d 822 (7th Cir. 1967); We berger v. New York Stock Exchange, 335 F. Supp. 139 (S.D.N.Y. 1971); Hughes v. Dempsey-Tegeler & Co., Inc., supra; Steinberg v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 1974 CCH Fed. Sec. L. Rep. ¶94,559 (S.D.N.Y. 1974), and Rich v. New York Stock Exchange, 1974 CCH Fed. Sec. L. Rep. ¶94,736 (S.D. N.Y. 1974).

The elements of such a claim for relief are now well established. In Marbury Management, Inc. v. Alfred Kohn, Wood, Walker & Co., 373 F.Supp. 140, 142-143 (S.D.N.Y. 1974):

> "A cause of action has been recognized, however, in favor of investors for a negligent violation of Section 6 by a national exchange, a cause adequately alleged by the plaintiffs in this case. Baird v. Franklin, 141 F.2d 238 (2nd Cir.) cert. denied 323 U.S. 737, 65 S. Ct. 38, 89 L.Ed. 591 (1944). In Baird, the leading case on the duties arising under Section 6, the Second Circuit states that a liability is restricted to cases where an exchange had notice of the violations of its members. In order for plaintiffs to succeed in such an action it must be able to prove: (1) that the Exchange had reason to believe or suspect that its member was acting in violation of the rules of the Exchange; (2) that the Exchange thereafter failed to take action; and (3) that such failure to act resulted in injury to plaintiff."

Each of the requisite allegations specified in the <u>Marbury</u> case, <u>supra</u>, is present in the amended complaint (Paragraphs 13, 15, 16, 17 and 18). Furthermore, the facts supporting each of these allegations were developed during pre-trial discovery procedures and were introducted in evidence at the trial of this action.

The absence of express mention of Section 6(b) in the amended complaint does not affect the sufficiency of the claim for relief asserted therein. Rule 8(a) of the Federal Rules of Civil Procedure states:

> "Claims for Relief. A pleading which sets forth a claim for relief, whether an original claim, counterclaim, cross-claim, or third-party claim, shall contain (1) a short and plain statement of the grounds upon which the court's jurisdiction depends, unless the court already has jurisdiction and the claim needs no new grounds of jurisdiction to support it, (2) a short and plain statement of the claim showing that the pleader is entitled to relief, and (3) a demand for judgment for the relief to which he deems himself entitled. Relief in the alternative or of several different types may be demanded."

The amended complaint in this action contains all of the allegations required by Rule 8(a) with respect to appellants' claims for relief against the New York Stock Exchange for violation of Section 6(b).

As stated in <u>Beeler</u> v. <u>United States</u>, 338 F.2d 687 (3rd. Cir. 1964) at 689:

"'A plaintiff is not required to state under what law he brings his action, but is only required to plead facts which under the law -- that is, any law applicable to the case -- entitle him to recover.'"

Similarly, in Siegelman v. Cunard White Star, 221 F.2d 189 (2d Cir. 1955), then Judge Harlan held at 196:

"It is not necessary to set out the legal theory on which the claim is based."

As stated by then Chief Judge Clark in Nagler v. Admiral Corporation, 248 F.2d 319 (2d Cir. 1957) at 328:

"For it is clear law that it is the duty of the court to grant the relief which the facts before it require; the legal theories which the parties may have suggested or relied on may be of help to the court, but do not control."

The claim of surprise and prejudice by the New York Stock Exchange is contradicted by the record. More than one year prior to the trial, proposed amendments of the pleadings were exchanged by counsel. The proposed amendments to the complaint expressly specified that a claim for relief for violation of Section 6(b) was being made. Furthermore, throughout the discovery process exclusively within six months prior to trial, counsel for the New York Stock Exchange was fully aware of the nature of the wrongdoing attributed to them. The District Court disregarded these events, relying instead upon the assertion of the jurisdictional bases for this action made by counsel for appellants in response to

a motion for a more definite statement by the New York Stock Exchange shortly after the commencement of this action. As stated in Jodice v. Calabrese, 344 F. Supp. 248 (S.D.N.Y. 1972) at 259:

> "It is incumbent on the defendants, though, to show actual prejudice, to demonstrate some undue disadvantage suffered by them in the presentation of the merits of their defense because of the amendment, for the court to exercise its discretion in their favor and deny plaintiffs' motion."

No such showing was made. As stated in United States v. International Business Machines Corp., 66 F.R.D. 223 (S.D.N.Y. 1975) at 228:

> "Numerous courts have held that the moving party's delay in seeking to amend a pleading is not, in and of itself, sufficient reason to deny the motion. 'Delay, inexcusable or excusable, is not alone sufficient to warrant denial of leave to amend.'"

Assuming that the New York Stock Exchange would have been prejudiced if the District Court had recognized the Section 6 claim, the District Court was free to grant a continuance of the trial to allow for the preparation and presentation evidence in defense of such a claim. In United States v. International Business Machines Corp., supra, Chief Judge Edelstein held at 231:

> "'While it is true that the allowance of the proposed amendment will present a question which may require additional preparation for trial by both the plaintiff and defendants, this is clearly no

ground for denial of the motin of the defendants.' [Citation omitted.] Similarly, any potential extension of trial time necessitated by amendment does not rise to the level of legal prejudice. Under modern fedeal practice, as a general rule, the entire controversy between two parties should be litigated as a unit. That doing so will make a case longer or more complex is not a sufficient reason to exclude certain issues from a case."

POINT IV

THE DISTRICT COURT ERRED IN REFUSING TO EXTEND APPELLANTS' FEDERAL SECURITIES LAW CLAIMS TO NON-SECURITIES

As previously stated, it was urged in response to the motion for summary judgment in the District Court that where a transaction involving both securities (limited partnership interests) and non-securities (general partnership interests) is alleged to have been violative of the anti-fraud provisions of the federal securities laws, damages resulting from the entire transaction may be recovered.

In rejecting this argument, the District Court made no reasoned analysis but attempted only to distinguish the authorities relied upon by Kohns and Mundheim. The District Court noted however that appellants' position had been adopted by the Ninth Circuit.

In the leading case of Errion v. Connell, 236 F.2d 447 (9th Cir. 1956), a federal securities law claim covering

both securities and non-securities was upheld. The Ninth Circuit held at 454:

> "Appellants argue that because non-securities are involved here as well as securities, that appellee should have brought her action in the state court. We disagree with this contention. We are of the opinion that the Act of 1934 was designed to cut out 'sharp practices' and fraudulent schemes involving securities, and the fact that there may be a co-mingling of securities with non-securities in the scheme does not oust the United States District Court of jurisdiction."

In Goodman v. H. Hentz & Co., 265 F.Supp. 440 (N.D. Ill. 1967), upon the authority of the Errion case, supra, it was held at 445:

> "In cases where a single fraudulent scheme involves both Securities and non-securities, a plaintiff may recover for both the Securities and non-securities in his action in the federal court."

More recently, in Hecht v. Harris,Upham & Co., 430 F.2d 1202 (9th Cir. 1970), the Ninth Circuit once again held:

> "When, as in this case, a single fraudulent scheme involves both securities and commodities a District Court is entitled to award damages for the entire loss."

These authorities recognize that Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. §78j(b)) and Rule 10b-5 promulgated thereunder (17 C.F.R. §240.10b-5), although prohibiting fraud in connection with the purchase or sale of securities, were intended to encompass all aspects of such schemes.

In this case, which presents an indivisible transaction, the Court should not blindly disregard the presence of non-securities and the damages suffered by Kohns and Mundheim with respect thereto.

CONCLUSION

For the foregoing reasons, the decision of the District Court should be reversed and judgment should be enterd for appellants.

Respectfully submitted,

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A 202 Affidavit of Personal Service of Papers

LUTZ APPELLATE PRINTERS, INC.

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT

Index No.

HOWARD C. HIRSCH, et al.,

Plaintiffs-Appellants,

- against -

EDMOND duPONT, et al.,
Defendants,
and
HASKINS & SELLS, et al.,
Defendants-Appellees.

Affidavit of Personal Service

STATE OF NEW YORK, COUNTY OF ss.:

I, Kevin E. Thomas, being duly sworn, depose and say that deponent is not a party to the action, is over 18 years of age and resides at 1515 Macombs Road, Bronx, N.Y. 10452,

That on the 12th day of November 1976 at 1. 80 Pine St. New York, N.Y.
2. One Chase Manhattan Plaza N.Y.C.

deponent served the annexed appellant's brief upon

1. David Hyde of Cahill, Gordon & Reindel 2. Russell Brooks of Milbank, Tweed, Hadley & McCloy

the attorneys in this action by delivering 2 true copyS thereof to said individual personally. Deponent knew the person so served to be the person mentioned and described in said papers as the herein,

Sworn to before me, this 12th
day of November 1976

Beth A. Hirsh
BETH A. HIRSH
NOTARY PUBLIC, State of New York
No. 41-4623156
Qualified in Queens County
Commission Expires March 30, 1978

Kevin E Thomas
Print name beneath signature
KEVIN E. THOMAS